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SME Access to Capital in Jordan

Final Report

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- Equipment Leasing
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- Factoring
- Venture Capital
- Working Capital
- Cash Flow Management
- Production-to-Sales Cycle
- Excess Liquidity
- Risk Management
- Loan Guarantee
- Know-How Transfer
- Lending Programs
- Banking Sector

Abstract

The Report presents the results of an investigation into the sources of capital which are or which may potentially become available to small and medium enterprises (SMEs) in Jordan. The Report documents the obstacles to access to capital for Jordan's SMEs and provides recommendations on how an integrated program of assistance can best be utilized to assist SMEs in gaining access to capital within the existing legal and regulatory framework. The Report makes further reference to where the existing legal and regulatory framework may itself be a factor limiting success and growth in the SME sector.

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Executive Summary

Small and medium enterprises (SMEs) are among the most active creators of new jobs and economic activity in developing economies. Growth in this sector is, however, typically inhibited by undercapitalization within the enterprise and limited access to capital from external sources. The limitation in access to capital arises as a result of the innate conservatism and restricted business models characteristic of Jordan's established capital sources – commercial banks – and a lack of development in the local intermediary financial institution (IFI) sector. Raising capital through equity or bond markets is not a viable alternative for SMEs in Jordan's still developing capital market environment.

An effective program to develop SME access to capital in Jordan should focus on the following measures: (i) the provision of incentives to commercial banks to support lending to SMEs through (a) provision of loan guarantees for 50 percent of the loan extended and (b) transfer of know-how in the efficient management of these programs (origination, approval, documentation and collection); (ii) a review and development of the existing legal and fiscal framework required to encourage both local commercial banks and IFI's to offer alternative forms of financing such as equipment leasing and receivables financing; (iii) the development of a venture capital market in Jordan including, where appropriate, public-private partnerships to support venture capital funds; and (iv) the provision of technical assistance to SME owner-managers to develop know-how in the areas of cash-flow management, financial reporting and strategic business development.

SME Access to Capital in Jordan

I. Introduction

Small and medium enterprises (SMEs) are among the most active creators of new jobs and economic activity in developing economies, as well as in many developed countries. Successful and growing SMEs are frequently at the cutting edge of a country's entry into new product areas, including high technologies, and into new export markets. However, the typical SME in a developing economy is family-owned, undercapitalized, and lacking know-how in key areas of business skills, including how to tap sources of financing and efficient financial planning and management. Sources of capital are typically limited to family-sourced financing and internally-generated earnings from the business. Broadening these limited sources of capital to permit the further growth of potentially successful SMEs is a major challenge to individual SMEs and to the SME sector generally. Related to this challenge is the parallel need to strengthen the skills level of SME managers (often owner-managers) in managing an expanding business, in such key skill areas as financial planning and management, market and product strategies, and human resources management in a growing business. Another often-undeveloped skill area in most SMEs is the ability to identify, and approach successfully, those sources of financing which in fact exist.

A parallel weakness of most developing economies is the relatively limited ability of local Intermediary Financial Institutions (IFI's) to provide financing to SMEs. This may be a function of limited liquidity and loanable funds, but is more frequently a function of the limited know-how which exists within the IFI's on how to provide financing to SMEs efficiently and at acceptable risk level. Absent such know-how, IFI's with ample financing capacity lack the incentive to serve the SME sector and instead focus their lending and investing on major corporations, affluent individuals, major projects and the State sector.

The challenge for any program aiming at strengthening the SME sector and its access to capital therefore has several elements:

(1) programs aimed at the SME sector and enterprises, to develop needed management and financing skills;
(2) programs aimed at local IFI's, to provide the know-how and incentives to finance the SME sector; and
(3) programs aimed at developing the financing instruments and framework in those areas where the capital requirements of SMEs are most readily met.

This report surveys the possibilities for expanding the access to capital to SMEs in Jordan. It concludes with a recommended set of programs aimed at the SME sector and SME financing based on types of donor (including USAID) programs which have been successful in other, similar country environments.

All programs aiming at the SME sector need to define an "SME". The definitions vary widely among donors and country environments. A typical donor-program definition of an SME might be:

(a) Ownership: an "SME" must be privately and locally owned (i.e. no affiliation with a larger or foreign enterprise, nor with the State)
(b) Employment: an "SME" employs between 10 and 50 people

(c) Annual sales: an “SME” has sales turnover of up to $1 million

By this definition, an “SME” fulfills all three of the above requirements.

The SME may be in any economic sector, be it trade, services or manufacturing.

The above definition would fit the SME environment of Jordan. Some programs, such as EU-based institutions and EBRD programs operating in Eastern Europe, use a larger SME definition, defining an SME as a company with sales up to EUR 5 million (equivalent to about $6 million). However, such larger definitions have been criticized as including the largest companies in the smaller Eastern European countries, and therefore not sufficiently targeted toward the small and medium enterprises in those countries.

Many bank-provided SME facilities also use a definition of the amount of financing needed, for example minimum $50,000 to maximum $250,000, in addition to the ownership, employment and sales turnover definitions.

II. Sources of SME capital

The typical SME is an owner-managed business which may be successfully operating but whose growth is limited by financing as well as know-how constraints. Owner and family capital, plus earnings from the business, are typically the only sources of financing for the business. To permit real growth of individual SMEs and the SME sector in the economy, other sources of capital must be identified and tapped by the SME.

There are two types of capital sources which may be identified: (1) Sources of capital which already exist in Jordan but to which access by SMEs is limited for various reasons. (2) Sources of SME capital which are still undeveloped or underdeveloped in Jordan. For the first category, programs to assist SME access to capital should focus on assisting the capital source, as well as the SME, to promote SME financing activity. For the second category, assistance programs should aim at developing the mechanisms for the lacking source of capital, while ensuring that such mechanisms are “SME-friendly”. A third category of programs can assist SMEs directly in developing the skills needed to tap the sources of capital which do exist.

(1) Capital sources which already exist in Jordan but where SME access is limited are:

a. Commercial bank credit (short-term working capital, medium-term equipment financing)

b. Capital markets (bonds, shares)

(2) SME capital sources which are still not well developed in Jordan:

a. Equipment leasing

b. Receivables financing (factoring)

c. Venture capital

III. SME financing needs

The typical SME financing need falls into one of the following two categories: (a) working capital, and (b) equipment financing.

a. <u>Working capital</u>

Working capital financing needs arise from the amount and timing of the SMEs cash cycle, and the amount of financing needed to support the profitable, and often growing, cash needs of the business. The cash cycle of any business involves outflows of cash to purchase materials, pay for labor and other costs, produce the product or service, then sell to a customer under agreed payment terms. The cash inflow only occurs when the company realizes a cash payment from the customer. In the production cycle of a profitable business, the amount of cash inflow should exceed the amount of cash outflow, but the timing of the outflow precedes the timing of the cash inflow from the final sale, often by a prolonged period of many months. This fact of timing of outflows and inflows creates a cash deficit in the business which must be financed, and in the absence of large amounts of shareholder capital, such financing needs must be met either by some form of bank credit or by some other credit source such as supplier financing or receivables financing. In the absence of such financing, an SME will either fail to meet its sales and growth opportunities, or (worse) will experience a cash crisis which could be, and often is, fatal to the business. This is the paradox of how a growing and profitable business can suddenly and unforeseeably become insolvent, unable to meet its debts to suppliers and other creditors.

Well-managed SMEs and prudent providers of capital to SMEs must understand this cash cycle and anticipate the resulting working capital financing needs. Because most SMEs lack internal financial information beyond accounting data, they are not well aware of the amounts or timing of the cash needs arising from the cash cycle (production to sales cycle). An SME which understands these cash needs (and an IFI which can meet them) should well understand and anticipate the amount of working capital needed, why it is needed (the cash outflow for factors of production), and how it will be repaid (the cash inflow from sales). Too often SME managers have an insufficient understanding of their production-to-sales cycle, and therefore underestimate the financing required to carry them through this cycle. This is particularly true in a growing business, because the mere fact of growth typically increases both the amount and the length of the cash cycle.

b. <u>Equipment financing</u>

SMEs which are successful and growing will need productive equipment to expand their production and meet sales opportunities. Initial equipment financing should be (but often is not) adequately covered by shareholder capital. As the business grows, external financing sources become desirable to finance new equipment purchases, which normally require several years to achieve their return on investment, and therefore the financing should be multi-year (typically up to three years for an SME). But in many developing or transition economies, the IFI's are not able or willing to provide medium-term financing, and the legal and regulatory framework is often lacking for equipment financing mechanisms. The result is either the SME underperforms because it is unable to acquire new equipment or the equipment is financed by short-term credit sources (an unhealthy arrangement for both borrower and lender). Occasionally equipment suppliers fill the gap and finance SME purchases of their equipment, but this source is typically limited to standard items such as vehicles.

SMEs often seek financing for unproductive purposes, such as to finance cash deficits which are the result of an excess of costs over revenues (net losses), hidden from view by inaccurate financial information; to finance excessive salaries, cars, real estate and other lifestyle benefits for the owner-managers; or to finance related family businesses (sometimes in hidden ways through inter-company commercial transactions, payables and receivables). Any capital source for SMEs must insist on clarity as to the purpose of the financing and the use of the funds, and on transparency in the SMEs financial information and management of funds.

IV. Commercial bank credit

Commercial bank credit is the first external source of capital to which an SME should be able to turn for financing its growing working capital or equipment financing needs. Jordan has the advantage of a relatively healthy banking sector, with numerous banks which are well-established and liquid. These banks are active in lending to the larger corporate sector, in project financing, and in retail lending to individuals, for example via home mortgage lending and other forms of consumer credit which are now growing rapidly. The banks typically invest excess liquidity in Government bills and bonds, and in other investment instruments. There is no lack of loanable funds in the commercial banking sector in Jordan.

However, typical of many developing economies, commercial bank lending to the SME sector is deficient. This lack of lending to SMEs is primarily a reflection of the banks' innate conservatism in asset creation and lack of incentives or inclination to date to develop credit programs aimed at the SME sector. This is in part, but not entirely, a matter of risk appetite on the banks' part. It is also due to a lack of know-how within the banks on the specific techniques used successfully elsewhere in lending to SMEs efficiently and in a way which keeps risks at an acceptable level. Efficient and prudent lending to SMEs requires techniques of analysis which are standardized, which aim at understanding the borrower's cash cycle and "ways out" of a credit in very specific terms, and which use efficient internal procedures for origination, approval, documentation and collection. It is not possible for banks to efficiently provide credit facilities to SMEs in the same way as this is done for larger corporate lending. A bank embarking on a program of SME lending must develop the know-how, the criteria and the procedures for this purpose. There is a long track record in other regions, such as Central and Eastern Europe, where donor programs have pointed the way toward such SME lending programs with commercial banks, providing certain incentives and know-how, after which the banking community as a whole begins to undertake active SME lending activity as a competitive business activity. The example of Bulgaria (see Appendix II) is an illustration of how, within a few years, initial donor programs assisting local banks in the techniques of SME lending have led to a situation where a majority of local banks are now competing aggressively for SME lending business.

This situation and experience elsewhere means than any program which encourages Jordan's commercial banks to expand their SME lending should focus on the following:

1. Providing incentives to the banks to expand SME lending, such as providing 50 % loan guarantees such as USAID frequently does in other, similar countries by using its DCA program.
2. Providing training and ongoing assistance to the lending banks in the specific techniques of SME lending, from program design to management of credit approval and monitoring processes.
3. Providing parallel programs of know-how transfer to SMEs, especially in the areas of financial accounting and management information, to assist the SMEs in understanding the financing needs of their business and in approaching external financing sources such as commercial banks.
4. Availability of funding is not a constraint for Jordanian banks, so a program promoting SME lending by commercial banks does not need to include a funding component.

Programs to expand access to commercial banking facilities for SMEs should not involve state or municipal entities or foresee the establishment of new financial entities for that purpose, unless such new entities are established on purely commercial and for-profit bases. Donor programs which use State structures to launch SME lending programs invariably encourage politically-driven allocation of credit, and/or lead to a moral hazard situation and poor loan performance when SME borrowers view the programs as, in effect, a state or donor-supported "grant" to which the borrowing does not need to be repaid.

V. Capital Markets

Additional shareholder equity, beyond start-up capital, is often required to finance the needs of a growing business. Relying exclusively on debt sources, even where they are available, will create a risky situation and excessive interest costs to the SME. Jordan has reasonably active, but limited, capital markets, with many listed companies and an active but limited group of institutions who raise funds through bond or share issues. However, the capital markets are not, nor will they foreseeably be, a source of capital for the SME sector, which by definition consists of enterprises too small, and otherwise lacking the qualifying characteristics, to participate in the capital markets. Attempts elsewhere by donor programs to establish share markets accessible to small business, and to promote IPO's by such businesses in developing or transition economies, inevitably fail. A better approach to the need for external capital is through programs which encourage and support specialized venture capital activities aimed at the SME sector.

VI. Equipment leasing

Equipment leasing is a common form of equipment financing for SMEs, which can be provided by non-bank leasing companies as well as by banks or bank leasing subsidiaries. However, leasing is not yet active in Jordan because the legal and fiscal environment for this activity is not yet in place. Recent laws passed in Jordan offer a partial solution, but the legal and fiscal treatment of leasing, and the rights of lessors (creditors) under current laws, remains unclear. A program of assistance to SME access to capital would usefully aim at clarifying this legal and fiscal environment, as well as educating financial institutions on how to use leasing as an important form of granting credit to SMEs.

VII. Receivables financing (factoring)

Receivables financing is also undeveloped in Jordan as a mechanism for expanding access to capital by SMEs. This form of financing requires the acceptance and use by SMEs, their customers and financial institutions, of instruments which represent evidence of debt and sources of cash flow against which a financial institution can provide financing to the SME. The legal environment (enforceability of the instrument against the SMEs customer as well as against the SME) is key to a successful use of receivables financing to expand SME access to capital from this source, turning sales into cash for the SME.

VIII. Venture capital financing

Venture capital financing typically aims at enterprises of larger dimension than SMEs. However, well-targeted venture capital programs, coupled with strict corporate governance and knowledge-enhancement programs for SME owner-managers, are increasingly used in certain developing or transition economies. Public-private partnerships for such venture funds, where a donor will participate with private venture capital sources in a venture fund aimed at SMEs, can be a realistic way to provide assess to equity or “mezzanine” capital for promising SMEs. The venture fund must have the manpower resources itself to sit on Board of the SMEs in which the fund invests; to play a hands-on role in financial management; and to provide other assistance and know-how to the business generally.

IX. Conclusion: An effective program for developing SME access to capital in Jordan

The above concepts point the way to the elements of an effective program to develop SME access to capital in Jordan. It is recommended that such a program consist of the elements listed below. Some of these elements can and should be undertaken soon, while others may need to be studied in detail before launching any program.

1. **Guarantee program supporting commercial banks’ lending to SMEs**

   Guarantees are typically for 50 % of the extended loans, and the loans and borrowers must meet a well-structured, but not overly restrictive, set of criteria for SME lending. Such programs, potentially under USAID DCA programs, have shown elsewhere that they can effectively provide the needed incentive for local banks to develop lending programs aimed at the SME sector. Such a program, to be effective, must be combined with technical assistance to the banks provided by experienced contractors (bankers with SME lending and program development experience).

A prerequisite for undertaking a guarantee program would be a survey of bank lending in Jordan presently to determine the concentration of lending to various categories of borrower (i.e. what percent of each banks' lending is to a given customer segment -- state entity, project, large corporate, SME, retail). Such a survey of Jordanian banks would also reveal which of the banks are potentially interested in participating in a future program to support SME lending (and which banks show, by not cooperating openly in the survey, that they are not interested).

2. **Development of SME financing instruments such as leasing and receivables financing**

   It will be useful to focus on the current status of the legal and regulatory framework for such forms of financing, not only in the formal sense but in the practical sense of how and to what extent any such financing is being done today in Jordan; what bottlenecks are preventing their utilization for SME financing and how are such bottlenecks overcome. The result of such a study should be to point the way toward programs to encourage present or new IFI's to provide the types of working capital (receivables financing) and equipment financing (leasing) which are outside the standard "loan product" menu of the commercial banks.

3. **Venture capital aimed at SMEs**

   The area of venture capital (VC) investment funds, targeted toward the SME sector, is relatively new but receiving growing interest and support on the part of donor programs in other regions such as Central and Eastern Europe. The concept is worthy of a serious study in the Jordanian context, potentially leading to a specific program mechanism. Some basic concepts of a venture capital fund, as they are being developed in other regions, include the following:

   1. Initial fund investors: Donor entities, plus private venture fund investors, plus additional share investors through an IPO (if feasible under capital market regulations).
   2. Investment targets: Profitable and growing SMEs requiring additional equity capital. Investment decisions are made carefully by a Board of Directors consisting of representatives of the major VC fund shareholders including the donor entities.
   3. The VC fund, through professional managers (individuals or a qualified firm) participates actively in the management of the SME in which the investment is made. This management presence in particular has a full view of the SMEs financial and cash management and of the company's accounts. Other forms of assistance may also be provided as may be required. Strict corporate governance processes are required of the SME as a result of the participation of the VC fund in the governing body of the company.
   4. The VC fund is managed toward a strictly commercial objective, i.e. a return on equity target is expected to be met by each investment. The cost of providing the management assistance and corporate governance in each SME in which the Fund invests should be built into the rate or return of the underlying investment instrument.

4. **Technical assistance to SME owner-managers**

   A program of assistance to SME owner-managers, to assist them in acquiring the know-how needed to effectively manage their business financially and to access external sources of capital, is an important part of the process of enhancing SME access to capital. Such programs should focus on the techniques of financial management for a small and growing business; the need for accurate and transparent financial information (not only accounting information but also cash flow information including forecasting cash needs). Such information, coupled with company product, market and staffing strategies, form the basis of the SMEs ability to successfully approach external sources of financing.

   Any top manager/owner, even if their background is in trading or manufacturing, should acquire the ability to prepare a company strategic and operating plan, including its financial and cash forecasting component. Such matters cannot be left to the company bookkeeper, nor should they be entrusted to outside experts—the top manager of the SME must be able to present the company, its track record, its future product and market strategies (SWOT analysis), and its financial condition and forecast financing needs, with cogent explanations for them, to the external financial source.

5. **An integrated program:**

   The above recommendations, taken together, form an integrated program of assistance to SMEs in Jordan, combining (1) assistance and incentives to existing banks/IFI's to target the SME sector; (2) development of new SME financing instruments, both debt and equity sources; (3) technical assistance and know-how transfer to SME owner/managers to help them successfully plan for, and have access to, external sources of financing for their business.

   These programs should explicitly aim to cover the various regions of Jordan, not only the capital where the bank headquarters and financial know-how are concentrated. A regional approach will ensure that the SME access to capital, and related know-how, reach those areas where is it likely to be scarcest at present.

   There are other areas which may be worthy of examination in such an integrated program of SME assistance, which go beyond the topic of access to capital. For example, the range of legal and regulatory impediments to business start-ups, growth and developments may be a factor in limiting the successful development and growth of the SME sector.

APPENDIX I: EXCERPTS FROM STUDY OF SME ACCESS TO CAPITAL IN BULGARIA

Financing of the SME, Micro-Enterprise and Agricultural Sectors in Bulgaria

A. Credit to the SME and Micro-Enterprise sector

Definitions of SMEs and Micro-Enterprises

1. EBRD programs in Bulgaria define an SME as a private company up to 100 employees (and up to 250 employees if it is a labor intensive activity), with annual turnover up to EUR 15 million, and with assets up to EUR 10 million.

2. USAID Sofia does not have its own SME definition but USAID typically uses the Bulgarian government definition for its programs in Bulgaria.

3. The current Bulgarian SME legal definition (the existing Act on SMEs) reads as follows:

   --micro-enterprise: employs up to 10 people, no threshold on annual turnover or assets

   -- small business: employs from 11 to 50 people, annual turnover of BGN 1 million, and value of long-term assets up to BGN 800,000.

   -- middle-sized business: employs from 51 to 100 people, annual turnover of BGN 3 million,
   and value of long-term assets up to BGN 2.4 million.

   Small and medium companies must meet an "independence" criterion, which is defined as "sole-proprietor, or an entity (company, or co-operative) in which not more than 25% of the share capital is held by shareholders other than SMEs."

   The following companies are not SMEs under the Act: publicly traded companies, companies with the following activities: banking, insurance, gambling, alcohol and spirits, wine production.

4. There is a new “Act on SMEs and Promotion of Business Activities” which is presently in its first reading in Parliament, and if it is passed, it is believed that it will take effect on January 1, 2004. The definition of SME in this new Act will be the same as the European Union is presently using, which Bulgaria must adopt before it enters the EU in 2007.

5. The EU definition, which Bulgaria will adopt of the new proposed SME Act is adopted, is as follows:

-- micro – enterprise: same as the existing definition in Bulgaria: employs up to 10 people, no threshold on annual turnover or assets

-- small enterprise: 11 to 50 employees, turnover up to Euro 1 million, and long-term assets up to Euro 800,000;

-- middle-sized enterprise: between 51 and 250, turnover up to Euro 3 million, and long-term assets up to Euro 2.4 million.

The independence criterion shall be applied as presently.

Problems faced by SMEs

SMEs are still underperforming as a force in the Bulgarian economy, due to regulatory burdens, legal system problems, and the need for many SMEs to compete with the unrecorded shadow economy. There remains a problem of lack of SME access to credit. However, banks are now highly liquid, many with SME lending programs, so SME access to bank credit has improved substantially over the past one or two years. However, total credit to the private sector is still only 16 % of GDP, very low by East European standards.

The capital markets are not a realistic option for SMEs. Most SMEs who cannot meet legal requirements for listing, and the markets themselves remain undeveloped.

A main obstacle to SME development is the frequent lack of managerial skills on the part of SME owners and managers. While technical and production skills are typically present, often at a high level, there is a clear lack of skill and experience in the SMEs in marketing, financial management, and general management in the sense of strategic thinking. Where this lack is apparent, and may harm the business's prospects, lenders note this and credit for an otherwise promising enterprise becomes difficult to obtain. The solution is in focused programs of training for the entrepreneur/owner/manager. USAID has funded a number of programs, which have offered management training aimed at the SME manager, including FLAG, AUBG, etc.

Equity financing for SMEs remains a gap in the range of venture funds operations. There is still a complete lack of venture investment capital in Bulgaria, which is focused on the locally owned Bulgarian SME. The best way to design a program of this kind is to establish a venture fund or guarantee program; working with local counterpart organizations such as BAEF together with its bank BACB which is active with SME credit; and combine this capability with training in SME management skills, enterprise "incubator" programs, and hands-on management advisory support for firms receiving venture investment from the program.

Loan guarantee schemes have been provided since about 1995 by donors through local banks, aimed at SMEs and other target borrower sectors such as agriculture. The experience with these programs has been mixed. The first program loan guarantee program was provided by the World Bank starting in 1994 through the then leading privately owned bank in Bulgaria, the First Private Bank. The utilization of this facility was very slow due to the bank's inability to quickly process loans meeting the World Bank criteria, and when the First Private Bank went bankrupt in the crisis of

1996, the program naturally ended. Since then, following the rehabilitation of the banking sector starting in 1997, a number of programs have been extended, which are as follows:

The success of such guarantees in terms of increasing the available credit for SMEs has been mixed. Of far greater importance to the availability of SME lending since 1999 has been the existence of a growing number of banks, which are well-capitalized, under more dynamic ownership and management with credit know-how, creating an increasingly competitive environment for banks in seeking to lend to the strongest and most promising SMEs. Banks, which have been promoting SME loan programs, include the following:

- DSK--State Savings Bank – SME lending
- United Bulgarian Bank – SME lending and USAID energy loan guarantee program
- Post bank – SME lending, USAID agro-business loan guarantee program
- Hebros Bank – SME lending (EBRD financing), USAID agro-business loan guarantee program
- Union Bank – SME lending (EBRD financing)
- Raiffeisen Bank(Bulgaria)AD – SME lending (EBRD financing)
- ProCredit Bank– the bank was established for SME lending
- Encouraging Bank – only SME lending
- Eurobank – SME lending
- First Investment Bank – SME lending
- Central Cooperative Bank – SME lending
- Economic and Investment Bank – SME lending
- Biochim Bank – SME lending
- SG Express Bank – SME lending
- Rossexim Bank – SME lending
- Bulgaria Invest Bank (Allianz Group) – SME lending
- Invest bank – SME lending, SAPARD, State Fund Agriculture, etc.

Programs aimed at SMEs and micro-credits are now very substantial.

B. Credit to the agricultural sector:

Since the early 1990's there are a number of programs supported by USAID, the World Bank and EBRD which have targeted the financing of the agricultural sector. The results have been mixed, with some successes and some failures, especially those programs operating through banks which proved either incapable of making loans meeting the program criteria, or which made loans to questionable borrowers, or which (the banks) themselves went bankrupt during the crisis of 1996-1997.

Examples of some agriculture finance-based programs are:

USAID's "RAPS" (Restructuring Agriculture and Privatizing State Entities) in 1994-96, managed by ACDI, Pragma, and Arizona State among others.

USAID's Warehouse Receipts program, managed by ACDI/VOCA and FLAG among others. This program was relatively successful in financing local agricultural enterprises, and has been continued with a US $50 million program provided by EBRD. Some of the benefit from this program has gone to major international commodity traders who operate commodity warehouses in Bulgaria.

In 1995-96 the World Bank had a program of loan guarantees to agriculture sector borrowers totaling US $100 million, but very little of that amount was used by participating banks that were unable to qualify loans under the program criteria. The only bank actively using this program, the First Private Bank, apparently made some non-collectible loans, and then that bank failed in 1996.

Recently, in 2003 USAID has concluded with two banks a loan guarantee program to cover 50 percent of the credit risk of loans up to five years extended to the agricultural sector, broadly defined to include producers of agricultural equipment. This program provides for a guarantee amount of US $10 million each to two banks, Postbank and Hebrosbank

3. USAID Financial Sector Programs in Bulgaria

The following USAID programs have taken place in Bulgaria (see also Attachment Five):

A. USAID Loan Guarantees under DCA program:

To date USAID has done five DCA credit guarantee programs, which are as follows:

--With United Bulgarian Bank: two guarantee programs in amounts of USD 6 million for SMEs, and USD 6,250 for lending to companies in the energy sectors.

--With First Investment Bank: guarantee program aimed in amounts up to $20 million for corporate loans and USAID is guaranteed up to $10 million, which is a partial guarantee on the loan principle. The term of this Guarantee Agreement signed by USAID and FIB on 10 September 2001 is seven years.

--With Hebros Bank and with Bulgarian Post Bank: USAID guarantee programs up to USD 10 million for each of these two banks (50 percent loan guarantee) for medium-term loans to the agricultural sector, including manufacturers of agricultural equipment.

The first three programs (United Bulgarian Bank and First Investment Bank) began in 1999 and have been actively used. USAID believes they have added value by encouraging these banks to make SME loans they otherwise would not have made.

The Hebros Bank and Bulgarian Post Bank DCA guarantee programs have just been concluded in 2003 and have not yet started operating.

USAID Sofia may wish to develop one more DCA guarantee program in the near future, but this is not certain.

B. USAID actively supports micro finance programs through Nachala (formerly Opportunity International) and CRS. USAID's Micro finance Programs

In September 1999 USAID-Sofia started a program to support three micro finance activities. The reason for this support was to increase income and employment in low income groups in Bulgaria, to increase the number of micro-business entrepreneurs, and to give better access to financial services for micro enterprises and SMEs.

The three USAID micro finance programs are (1) Nachala (first organized as NGO in 1993 to begin small lending programs), (2) Catholic Relief Services (CRS) , and (3) World Council of Credit Unions (WOCCU). Loans from these programs are used to finance micro and small business operations, consumer purchases, education of children, purchases of land, buildings and equipment. Loans need to be paid in one year or less.

Most borrowers seem to pay in a normal way and the programs have low bad loan rates. There are several reasons for this good repayment rate. The programs know their borrowers well and carefully select those to whom they give loans.

The total loan portfolios of the three USAID sponsored programs have reached above USD 5.6 million, with an average size loan of about USD 950. The three programs are now expected to have loan growth for 2003 of about 60 percent.

The success of USAID and other donor micro finance and SME lending programs with non-banking financial institutions is that their has been an increased interest of many commercial banks to do the micro and SME lending over the past year.

Ministry of Labor and Social Policy (MLSP) has developed a micro lending program through commercial banks. This program is called "King's Loans". The size of the loans is up to Leva 5,000 with 50 percent guarantee by the MLSP. Most of the commercial banks are offering this micro lending program to their clients, especially for the start up business entrepreneurs.

The ProCredit bank opened as a micro finance bank with EBRD and Commerz bank as shareholders, and it is providing loans to SME and micro-enterprises with competitive loan terms and various maturities.

These USAID programs have helped banks to understand that micro-finance and SME lending can be done safely and profitably in Bulgaria. Micro and SME lending is becoming more competitive and part of normal banking in Bulgaria.

The three USAID micro finance programs are summarized as follows:

A. Nachala, a Cooperative supported by Opportunity International (OI)

The Nachala NGO was established in 1993 with support of OI (a global coalition of Micro Finance Institutions. . The purpose of Nachala Cooperative was to provide small business training and to manage a micro and small business-lending program for the Bulgarian American Enterprise Fund (BAEF). The NGO received fees for originating loans for the BAEF. These loans were made from late 1993 until middle of 1996. The BAEF portfolio has been liquidated, except for a number of loans still in the collection process. BAEF established Bulgarian American Credit Bank (BACB) in 1997, which is providing loans to SME companies. Nachala being registered as a credit cooperative in 1997. Nachala Cooperative started by taking over the staff and offices of the Nachala NGO and began lending in late 1997 with financial support from USAID channeled through OI.

B. USTOI (supported by Catholic Relief Services CRS)

The mission of USTOI, NGO (the meaning in Bulgarian means “support”) is to increase income and employment of micro – entrepreneurs in Bulgaria. USTOI supports micro business development by providing entrepreneurs with access to financial services.

C. Kasas (supported by World Council of Credit Unions WCCU)

The Employee Mutual Kasas is a structure that has been operating since 1950, and served as a means for employees to take small and relatively inexpensive loans. The Cooperative Mutual Kasas (CMK) developed as a result of some changes in Cooperative Legislation in 1997. They provide loans to members of cooperative based upon competitive market rates. CMK have a community character and are limited to only servicing members. These mutual Kasas operate by requiring each member to make a monthly share contribution directly from their salary. WCCU, which manages long-term technical assistance program to develop, strengthen and modernize credit unions and credit union systems around the world, is providing technical support to thirteen of the CMK and has plans to assist a larger number.

It is assumed that USAID will continue to provide financial support to these micro-lending programs. Other donor and debt funding should also be attracted to support these programs. Also, greater stimulation of micro lending could be done by USAID guarantee programs specifically targeted to micro lending.

Also, there could be a more specific legal and regulatory framework for regulating non-bank financial institutions, to help the sector grow further and expand its assistance in micro lending. This would allow these NGO to operate in a more clear regulatory and supervision framework, coming under the supervision of the Central Bank.

A. USAID actively supports credit programs developed by the Bulgarian American Enterprise Fund and its subsidiary the Bulgarian American Credit Bank. This includes mortgage lending, SME credit, and the new initiative to set up a special purpose vehicle under the new SPV law for purchasing receivables including mortgage receivables.

B. USAID has assisted in the development of the Deposit Insurance Fund, which is now operating in a satisfactory way. USAID has assisted of the establishment of Pledge Registry, which was very timely and helpful for the lending activities of the commercial banks and as well as of other lending financial institutions and financial sponsor’s programs such as SAPARD, PHARE, etc.

C. USAID and its Bulgaria Capital Markets Project, managed by Carana and Multinational Strategies, played a major role in the development of new financial market debt instruments, specifically the Mortgage Bond legislation that was passed in 2000. Since then, several banks, especially BACB, have used this instrument to finance their growing portfolio of home mortgage loans, a rapidly expanding credit activity. The USAID Capital Markets Project also worked with financial institutions In Bulgaria to develop other debt instruments, such as corporate bonds, holding workshops and seminars attended by leading intermediaries, issuers and institutional investors. (See Attachment Three—Bonds Issued).

D. USAID Bulgaria Capital Market Regulations Project was attached to the Security Commission and provided assistance to the Commission. This Project also assisted in developing new legislation regulations on trading of securities.

E. USAID has also supported a bank training program at the International Banking Institute (jointly owned by the Bulgarian National Bank and the Association of Commercial Banks), managed by KPMG-Barents Group.

INFORMATION ON SME AND MICRO-LENDING PROGRAMS UNDER USAID, EBRD AND OTHER PROGRAMS IN BULGARIA

1. USAID Guaranteed loans to SMEs through United Bulgarian Bank:

USAID guarantees 50 percent of the credit risk of loan principal. Total guarantees under the program are US $6 million. Program is valid until November 2004.

Beneficiaries and amounts:

--Micro-enterprises with no more than 5 employees may receive credits up to US $5,000.

--SMEs with assets (not including real estate) not exceeding US $250,000 may receive credits up to US $150,000.

--Borrowers must be 100 percent Bulgarian companies (no participation by foreign companies).

Conditions: Interest rate: 14% to 16 % p.a. (Leva loans)
Collateral: normal according to banking practice.

Contact: United Bulgarian Bank, Tel: (02) 9854 2217

2. USAID Guaranteed loans to the energy sector through United Bulgarian Bank:

USAID guarantees 50 percent of the credit risk of loan principal. Total guarantees under the program are US $6.25 million. The program is valid until September 2006.

Beneficiaries:

--Enterprises engaged in the production, distribution and utilization of energy resources in Bulgaria..

Conditions: Interest rate: 14 to 16 % p.a. (Leva loans)
Collateral: normal according to banking practice.

Contact: United Bulgarian Bank
Tel: (02) 9854 2217

3. EBRD-supported SME lending program at Raiffeisenbank (Bulgaria):

Beneficiaries:

--SME lending program: Private companies with up to 100 employees meeting EBRD eligibility criteria (private Bulgarian-owned, all sectors except excluded ones of armaments, tobacco, alcohol). Loans up to two years, in amounts of between US $20,000 and US $100,000.

--Micro-lending "Initiatives" program: Firms with up to seven employees. Loan amounts of between Euros 2,000 and Euros 30,000.

Contact: Mr. Svetoslav Perinkov,
Raiffeisenbank (Bulgaria)
Tel (02) 91985107
www.rbb.bg

4. EBRD-supported SME lending program "Perspectives" at Hebrosbank

Beneficiaries: SMEs meeting EBRD criteria (same as above).
Conditions: Loans up to three years, for amounts up to BGN 250,000.
Contact: Mr. Ivan Balabanov, Hebrosbank
Tel: 9260500.
www.hebros.bg

5.SME lending programs of Encouragement Bank

Contact: Tel (02) 960-6633
e-mail: office@nasbank.bg
www.nasbank.bg

6. CRS Bulgaria

tel 944-1837, e-mail crsbg@crs-bg.org
Micro-Finance Program.
Beneficiaries: Small enterprises (one-person or small family companies). No other restrictions.
Amounts lent: Between BGN 900 and 3,600 (first amount 900), without collateral.

Program operates since 1998 in Vidin and Sliven regions, plans to expand throughout the country.
Donor relations: USAID-supported.

7. National Network for Micro-Funding

Bulgarian Industrial Association. Tel 987-9929 or 980-1090,
email kamen@bia-bg.com
(in cooperation with the DSK Bank).

Beneficiaries: SMEs

Amounts: between BGN 5,000 and 50,000,
Conditions: Medium-term, grace period up to 3 years,
Interest rate 14.5 %.
Credits only for production purposes.
Borrower must invest at least 30 % of project.

8. KfW (Gernamy) program for SME lending

Program managed by Bulgarian National Bank (APEX)
Amount totals DM 10 million (now Euros).
Lending banks in Bulgaria are Eurobank and Unionbank

Beneficiaries: micro- and SME enterprises from all sectors, privately-owned, at least 51 % Bulgarian ownership, maximum 50 full-time employees, company in business successfully for at least 6 months.

Loan amounts and conditions: Leva or currency equivalent of minimum DM 1,000, and maximum DM 50,000. Term of credit up to 24 months. Normal bank collateral.

Contact: Eurobank, tel Sofia (02) 687-016, Plovdiv (032) 628007
www.eurobank.bg/kfw.htm
Unionbank: tel (Sofia) 987-6002
www.unionbank.bg/index_.htm

9. Credit Line under PHARE program:

Funds granted by the EU under agreement with Bulgarian Ministry of Industry.
Bulgarian National Bank (APEX) provides funds for lending by SG Expressbank, Bulgarian Post Bank, and Central Cooperative Bank.

Beneficiaries: Bulgarian SMEs. Loans must create jobs, generate exports, and Develop the following sectors: Transport, Industry, Agricultural processing, and Tourism.
Not eligible: Agriculture, real estate or trade activities.

Loan amounts and conditions:
--Up to Euros 100,000.

--Beneficiary must co-finance up to 25 % of project value.
--Loans for up to 5 years, grace period up to 2 years.
--Floating interest rate based on EUOR LIBOR.

Contacts:
SG Expressbank, Varna, phone (052) 601548
Bulgarian Post Bank, Sofia, phone (02) 963-1696
Central Cooperative Bank, Sofia, phone (02) 984438

10.Caresback-Bulgaria SME lending program

Contact: Mr. Ivaylo Simov, Mrs. Maria Vassileva
Tel (02) 467-270 or (042) 22095
e-mail: caresbac@techno-link.com

11. Dutch Government programs "PSO"

Eligible beneficiaries: Bulgarian SMEs which have Dutch partner companies may benefit from a variety of types of assistance through this program, including investments, technical assistance and know-how. Sectors covered are agriculture, transport, energy, environment, industry.

Contact: Ministry of Economy (Mrs. Nadia Dondolova)
Tel (020) 987-4992
www.senter.nl/pso

12. SME credit line program of Swiss foundation "FAEL"

The total credit program is for Swiss Francs 1 million. The loans are provided through the United Bulgarian Bank.

Eligible companies: SMEs located in the Northern Balkan mountain regions of Lovetch, Gabrovo and Veliko Turnovo (area of operation of FAEL), with two years business history,
operate in this region, create jobs, and protect the environment.

Conditions: Program provides consultant support, training, credit support, and technical assistance.

Contacts: FAEL Foundation, Sofia (02) 946-1984, Lovech (068) 26204

13.Programs of State Fund Agriculture

There are seven different programs, which provide credits to small agricultural enterprises, or for specific purposes.

Eligible borrowers: Agricultural producers.

Programs and loan amounts:
--"Agricultural Start": up to BGN 15,000
--"Bulgarian Farm": up to BGN 10,000, or up to BGN 90,000 depending on purpose.
--"Development": Projects up to BGN 260,000, loan amount up to BGN 182,000 (70 percent \ of project).
--Mountain Agriculture: Up to BGN 15,000, certain locations eligible.
--Ecoagriculture: Projects up to BGN 80,000, credits up to BGN 60,000.
--Young Agricultural Worker: Investment credits up to BGN 15,000, borrowers must be individuals up to age 35.

--Glasshouses: Credits for investing in new or existing glasshouses (greenhouses), project value up to BGN 1 million, credit up to BGN 650,000 (own participation 35 percent).

Contacts: State Fund Agriculture, regional directorates.
--Telephone in Sofia: (02) 951-6669.

14. SAPARD program:

The SAPARD program within the EU framework is for amounts of Euros 52 million annually.

Priority sectors for SAPARD funds are:

--Improvement of conditions of production, processing and marketing of agricultural, forestry and fish products up to European norms and standards.
--Development of rural regions to protect their economic and resource potential
--Development of ecological agriculture and preserving the environment.
--Qualification and training of workers in agriculture, forestry and fish production.

Beneficiaries: Privately-owned SMEs in the agricultural, forestry and fish production sectors.

Conditions: Eligible projects will be funded 50 % by SAPARD, and the other 50 % will be funded by credits (including credits from State Fund Agriculture, who is Paying Agent
under this program), and co-funding by the beneficiaries.

Contact: Tel. (02) 981-5951
e-mail: dfz@sps-elsys.com

15. Ministry of Labor and Social Policy programs:

These programs include financial support for start-up businesses (program "Start Your Own Business", through the National Employment Services and BARDA Regional Business Centers in municipalities around Bulgaria.

Beneficiaries: Unemployed persons

Contacts: Regional Labor Bureaus.

16. SME Business Incubator program of the United Nations Development Program (UNDP)

This program provides business assistance and financial aid in various forms in the towns of Razlog, Vidin, Blagoevgrad (business centers) and Gotze Delchev (business incubator). Training is provided with materials from the International Labor Organization.

Beneficiaries: Local SMEs, potential entrepreneurs, and individuals wishing to start their own business.

Credit available: Financial assistance is available through a micro-credit facility in Vidin and a leasing line in Gotze Delchev.

Contacts: UNDP Sofia, Mrs. Elena Panova, tel (02) 9609 5215
Business Center, Razlog, tel (0747) 6464
Business Center, Vidin, tel (094) 24244
Business Center, Blagoevgrad, tel (073) 36883
Business Incubator, Gotze Delchev, tel (0751) 2346